FRBSF Weekly Letter

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Interstate Banking in the West

This may be the year that the Congress finally lifts the federal restrictions on interstate banking. The House recently passed an interstate branching bill, and in the Senate a bill has been passed along by the Banking Committee.

While this federal legislation on branching is important, it will be more like the finishing touch than the foundation for interstate banking. That is because over the past ten years or so the states themselves have seized the initiative, sweeping away restrictions on interstate banking and dramatically changing the banking landscape. This is particularly true here in the West, where interstate banking has arrived and is thriving.

This *Weekly Letter* profiles interstate banking in the Twelfth Federal Reserve District by looking at the extent of cross-border banking and the types of banks involved. It also discusses the effects of interstate banking on industry structure and the availability of bank credit.

Legal legacy

The federal restrictions on interstate banking date back almost 70 years. Going back to 1927, the McFadden Act restricted bank branching across state lines, and the Bank Holding Company Act of 1956 restricted holding companies from operating full service banks across state lines. The federal restrictions are binding unless a state opts to permit interstate banking. For many years few states gave such permission, so, with a few exceptions, interstate banking was limited to narrow service operations such as loan offices and other nonbanking holding company subsidiaries. An important exception in the West is First Interstate Bancorp, which operated banks in several states under a grandfather provision in the Bank Holding Company Act.

A small crack in the federal prohibition on interstate banking opened up in the 1980s. Bank holding companies (BHCs) were allowed to move across state lines to acquire financially troubled institutions. The policy was intended to increase the pool of bidders for failing banks and thrifts and thus reduce losses to the deposit insurance system.

The states, however, have taken the major steps to tear down the geographic barriers to banking, mainly over the past ten years or so. Before the early 1980s, only a few states allowed any interstate banking. Today all states but one allow entry by out-of-state BHCs, with 34 (including the District of Columbia) allowing it on a national basis and the others limiting access to BHCs operating in specific states. A handful of states also permit interstate branching on a reciprocal basis.

Here in the Twelfth Federal Reserve District, all the states, except Hawaii, allow some form of interstate banking. Alaska, Arizona, California, Idaho, Nevada, Oregon, and Utah allow interstate banking for bank holding companies in all other states, while Washington allows access nationally on a reciprocal basis. Alaska and Oregon also permit interstate branching.

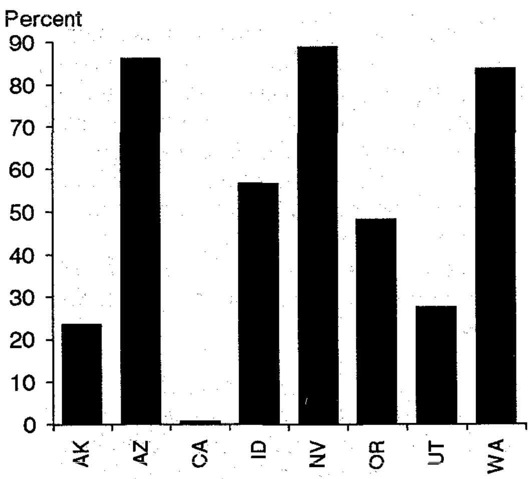
Profile of the West

For many states in the West, interstate banking dominates the banking landscape (see the top panel of the Figure; the out-of-state BHCs are domestic holding companies). Based on share of assets, Nevada leads the pack, with out-of-state BHCs accounting for over 90 percent of its banking assets. This includes two credit card banks owned by out-of-state holding companies, but the share of assets is still high when they are excluded. The lion's share of bank assets in Arizona and Washington is held by interstate banks, and Idaho and Oregon have relatively large shares. The figures for Alaska and Utah are closer to the national average, while California's share is low. Hawaii currently does not allow interstate banking, but BankAmerica in California operates a large thrift in the islands. The holding company was able to make the acquisition through a thrift subsidiary in Oregon because the federal restrictions on interstate banking do not apply to thrifts.

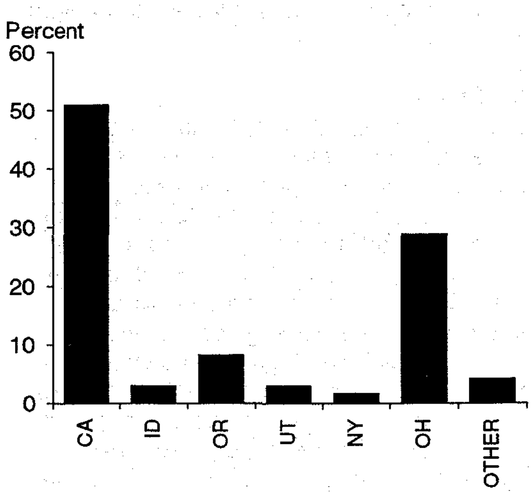
The differences in the shares of assets held by interstate banks may represent special factors as well as more intrinsic differences among the western states. In Arizona, for example, the interstate banking surge in part involved acquisitions of several financially troubled thrift institutions

Figure
Twelfth District Commercial Bank Assets Controlled by Out-of-State BHCs

By State



By BHC Home State



Note: Assets are as of June 1993; structure is as of March 1994

in addition to commercial banks. In the case of Alaska, its remoteness may be a factor limiting the extent of interstate banking to date.

Economic conditions in a state also could be expected to have an impact on the shift to interstate banking. Idaho, for example, with its rapidly growing economy, has been a target for banks looking to expand geographically. California, on the other hand, has been in a deep and prolonged recession since mid-1990 and has attracted relatively little in the way of interstate banking. But even if the state's economy were healthier, California might not be the ideal target for some out-of-state holding companies. For example, some large banks might want to look for new markets to take advantage of the scope of their banking services. In that case, they would probably prefer to expand to smaller states where the size of the market may have limited banking, rather than to California, which has some of the largest banks in the country as well as several banks owned by very large foreign holding companies.

The players

Though interstate banking in the West is open to holding companies from around the country, most of the cross-border banking has been initiated by BHCs within the Twelfth District. Moreover, the activity is dominated by only a few banks, of which California banks are the most important players. The bottom panel of the Figure shows that California-based BHCs accounted for about half of the interstate banking (assets) in the District. California's share mainly represents the activities of two holding companies, BankAmerica and First Interstate, both of which have a presence throughout the District and beyond.

The other players in the West have tended to focus their acquisitions more regionally. U.S. Bancorp, which accounts for Oregon's share of interstate banking in the West, owns banks in the District states of California, Nevada, Idaho, and Washington. From Utah, First Security Corporation operates commercial banks in the District states of Idaho and Nevada. Zions Bancorporation in Utah has expanded to Arizona and Nevada, while West One Bancorp in Idaho has banks in Oregon, Utah, and Washington.

There also are only a few prominent competitors from outside of the District; the most widely represented one is Keycorp (now headquartered in Ohio), which operates banks in Alaska, Idaho, Oregon, Utah, and Washington. Another Ohio BHC, Banc One Corporation, has added banks in Arizona, California, and Utah to its portfolio of interstate banks. The interstate banking presence of large New York banks in the West is somewhat limited and has been declining. Citicorp in New York operates commercial banks in California and Nevada, though the Nevada bank is a credit card bank and not a full service commercial bank. It also has a sizable savings institution in California, which is not reflected in the data in the Figure. However, Citicorp recently sold an Arizona bank to Norwest Corporation in Minnesota, and First Interstate has applied to acquire Chase Bank of Arizona.

Banking structure

The overall share of interstate banking in the West accounted for by holding companies from outside the Twelfth District suggests that widespread—even nationwide—banking networks are feasible. Still it is striking that western holding companies have dominated interstate banking in the West. This suggests that there are some regional factors in banking that likely will keep it from evolving naturally into a system consisting of just a few nationwide "megabanks."

Moreover, even in states where interstate banks dominate, they still are competing with a relatively large number of independent banks. In fact, of the over 700 banks operating in the Twelfth District, less than 10 percent are operated by an out-of-state holding company. This means that even if nationwide branching is enacted and all interstate banks are converted to branches (which is unlikely), there still would be a large number of banks in the system.

Impact on lending

A common concern about permitting interstate banking is that out-of-state banks will not provide the same level of services as "home-grown" banks. At one extreme is the concern that out-of-state banking organizations are looking to raid local deposit markets and use the funds for lending in their home states. Underlying this concern is a view that interstate banking organizations have an intrinsic interest in bonding only with their home states. But that is not the case. Rather, banks have an incentive to allocate credit to the highest valued uses, taking into account risk.

With that incentive, it is possible for interstate banking to have an effect on lending, but it could go either way. If interstate banking organizations are better than single-state banks at moving funds around, and if returns on the marginal lending in a given state are low, interstate banking might mean less lending in that state. By the same token, however, if returns on lending tend to be high in a state, interstate banking could mean more lending in that state.

Interstate banking also could affect bank credit through its effects on risk. Bank performance in different states is not perfectly correlated. This means that an interstate banking acquisition can provide greater diversification and less risk compared to operating the same banks separately. Some models of bank behavior predict that lower overall risk from an interstate acquisition would lead an institution to adjust its portfolio, perhaps by changing the composition of assets or even by lending more. If lending were increased, the allocation would depend on the investment opportunities in different banking markets.

Beyond the theoretical considerations, the empirical evidence suggests interstate banking does not systematically reduce lending in the affected states. Statistical analysis of individual banks in the Twelfth District did not reveal a significant difference in the loan growth at banks owned by holding companies headquartered in another state and other banks. Likewise, no relationship was found between growth in loans for each of the 50 states and the degree of interstate banking in the states. Both sets of analysis controlled for economic and banking conditions.

Conclusion

The tide of interstate banking has swept over many of the states in the West. The consolidation of banking should allow for a more natural banking industry structure to develop. The pattern in the West suggests that there are regional factors that likely will keep banking from evolving into a system consisting of just a few nationwide "megabanks." The system emerging in the West includes two very large interstate banking groups, several regional interstate banking groups, and a large number of single-state banks, including many small banks. Beyond the effect on the banking landscape, the spread of interstate banking has the potential to improve the allocation of credit and increase overall lending.

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